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SIPDIS

DEPT FOR AF/E, AF/RSA
DEPT ALSO PASS TO USTR FOR BILL JACKSON
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TAGS: [ECON](#) [EFIN](#) [KE](#)
SUBJECT: Drought and Oil Prices Drive Kenya's Inflation
Rate Up

REF: Nairobi 1614

Summary:

[¶1.](#) Drought-induced food price increases and rising oil prices caused Kenya's overall inflation rate in March 2006 to jump 19.4% compared to March 2005. This will exacerbate poverty in Kenya, where over half the population is unemployed and living on less than \$1/day. However, underlying inflation, which excludes volatile food and energy, has been holding steady at about 5%. The Central Bank of Kenya's (CBK) monetary policy appears to be effective at keeping interest rates stable, and the shilling has remained strong. Even if the impending rainy season provides normal rainfall, energy and food prices will likely continue to rise and feed inflation, and may reduce 2006 GDP growth below the CBK's 5% forecast. End summary

How the GOK Measures Inflation

[¶2.](#) The CBK and the Central Bureau of Statistics (CBS) use several different statistics to measure inflation. The CBS releases Consumer Price Indices (CPI) and inflation rates on a monthly basis. The CPI is based on data collected from selected retail outlets in 13 urban centers in the second and third week of the month, and is believed to represent the spending behavior of Kenyan urban households. The Consumer Price Index is used to calculate two rates of inflation; overall and underlying. The overall rate of inflation includes prices for the following categories of goods and services. The CBK calculates overall inflation for Nairobi lower and middle/upper income groups and varies the weighting for each category of goods and services by income group. CBK also calculates overall inflation for the other 12 urban centers in the survey.

Food and drink
Alcohol and tobacco
Clothing and footwear
Housing
Fuel and power (energy)
Household goods and services
Medical goods and services
Transportation and Communication
Recreation and Education
Personal Goods and services

[¶3.](#) The underlying rate of inflation excludes the volatile categories of food, energy and transport/communication. The CBK targets the underlying rate in its monetary policy

planning and implementation.

¶4. The CBS and CBK use changes in the CPI to calculate several time-series measures of inflation. The titles they use for these measures are misleading and inconsistent, and media reports are even more so. Here are the translations.

Month-on-Month or 12-month: Actually year-on-year (YOY) change in prices, since it compares the CPI in the current month with the CPI in same month in the previous year. Example: Feb 2006 month-on-month or 12-month inflation is the change from Feb 2005 CPI to the Feb 2006 CPI. This report will refer to this measure as YOY change.

Growth over one month: Change in CPI from the previous month. Example: Feb 2006 growth over one month is the change in CPI from January 2006. This report will refer to this measure as MOM change.

Average Annual: Compares average CPI for the last 12 months with the average CPI of the preceding 12 months. This measure serves as the seasonally-adjusted inflation rate, and is less volatile. Example: Average annual inflation in Feb 2006 is the change from the average Feb 2005-Feb 2006 CPI and the average Feb 2004-Feb 2005 CPI. This report will refer to this measure as average annual change.

Drought Pushes Overall Inflation to New Heights

¶5. Drought-induced increases in the price of food and beverages pushed the March 2006 YOY overall inflation rate to 19.4%, the highest YOY rate since September 2004. In the 12 months since March 2005, food and beverage prices have risen 29%, followed by energy at 12.6%, and alcohol

and tobacco at 10.2%. The overall inflation rate rose 1.7% MOM in March, a smaller jump than the February 4% MOM or January 8.7% increases. The average annual rate of inflation, which is effectively seasonally adjusted, rose 11.36% in March. The average annual inflation rate has been rising since December 2005, after declining in the second half of 2005. Outside of Nairobi, March YOY inflation was 14.5%, higher than the February increase of 11.2%.

¶6. Wages have not increased to match the inflation. Over 50% of Kenyans live on less than one dollar/day, and unemployment is over 50%, so this high inflation is pushing workers and consumers deeper into the hole, exacerbating poverty.

Underlying Inflation Is Lower and Within CBK Target Range

¶7. Excluding increases in the volatile food, energy and transportation/communication categories creates a different picture. The average annual underlying inflation rate has been declining since September 2005, and fell to 5.08% in March 2006. This is within the CBK's target range for

monetary policy. Stable interest rates and the continued strength of the shilling against the dollar indicate the CBK monetary policy remains effective, despite the drought and rising world oil prices.

¶8. In its annual monetary policy statement released in March 2006, the CBK confirmed it would continue the policy set in October 2005, but make the necessary adjustments to compensate for the drought and financing of drought relief operations by the government. CBK Governor Andrew Mullei said the CBK maintained its 5% inflation target, would work to ensure that the current high inflation does not translate into inflation expectations. The target growth of money - known as reserve money - will be at an average of 7 per cent for 2006 to keep interest rates stable and low enough to support economic activity. The CBK controls reserve money through sales and purchases of government

securities to commercial banks under repurchase agreements (REPOs).

¶9. Making the task of controlling inflation more difficult, electricity prices will rise 17% to 8.2/kwh shillings on June 1. The increase is a one-year surcharge for diesel-generated power needed to compensate for the drought-induced shortage of hydro-electric power. Although the supplemental generators are supposed to avoid the need for power rationing, the increase in Kenya's already high power costs will further degrade Kenya's international competitiveness.

Impact on GDP Forecasts

¶10. The CBK's latest forecast was that overall inflation increases would slow as the onset of the long rainy season relieves the drought in many places and leads to increased food production. However, Kenya Shell managing director Patrick Obath said fuel prices were likely to increase this year due to surging international prices. Nairobi Stock Exchange (NSE) Chief Executive Chris Mwebesa also warned the inflation rate was set to rise further as effects of the drought continue to bite. Mwebesa predicted that GDP growth rate would be reduced to 4.5-5.5% in 2006, after growing at about 5.2% in 2005. The CBK has reduced its 2006 GDP growth estimate from 6% to 5.5% because of the drought.

Comments

¶10. It is unfortunate that drought, rising food and energy prices will make managing Kenya's economy more difficult at a time when the GOK is struggling to deal with grand-scale corruption scandals and politicians are increasingly focused on the December 2007 general elections. Although CBK Governor Mullei was recently suspended for allegedly steering relatively small consulting contracts to his son's firm, there is no indication yet of any change in the CBK's management of monetary policy. (Ref A, classified.) The long rains started on time, and have even caused flood damage in some parts of the country. However, it is still too soon to determine whether the rains will refill the

reservoirs behind the hydro-electric dams, will maintain food production, and reduce the need for the GOK to provide food assistance to the arid areas in the north and northeast. End comment.

Table 1
Overall Inflation, 2005-2006, based on Central Bureau of Statistics Consumer Price Index. All numbers are percentages.

	CPI	MOM change	YOY change	Average
Annual				
2005	-----	-----	-----	-----
Jan	174.4	1.28	14.87	12.1
Feb	176.1	0.97	13.94	12.43
Mar	178.6	1.42	14.15	12.91
Apr	183.4	2.69	16.02	13.62
May	184.5	0.60	14.78	14.48
Jun	182.5	-1.08	11.91	14.97
Jul	181.1	-0.75	11.77	15.21
Aug	182.1	0.53	6.96	14.41
Sept	179.4	-1.49	4.27	13.13
Oct	179.8	0.25	3.72	11.89
Nov	182.0	1.18	6.04	11.01
Dec	185.2	1.77	7.56	10.31
2006				
Jan	201.3	8.68	15.39	10.41
Feb	209.3	4.01	18.87	10.88
Mar	212.8	1.66	19.14	11.36

Table 2
Underlying Inflation, 2005-2006, based on Central Bureau of
Statistics Consumer Price Index. All numbers are
percentages.

	MOM change	YOY change	Average Annual
	-----	-----	-----
2005			
Jan	1.32	4.93	3.64
Feb	0.32	5.21	3.86
Mar	0.28	5.31	4.09
Apr	0.48	5.9	4.41
May	0.47	6.42	4.78
Jun	0.61	5.79	5.01
Jul	0.24	5.95	5.22
Aug	0.17	5.48	5.35
Sept	0.23	5.39	5.43
Oct	0.13	4.79	5.42
Nov	0.12	4.69	5.39
Dec	2.17	4.94	5.4
2006			
Jan	1.66	4.0	5.31
Feb	1.05	3.94	5.2
Mar	--	3.82	5.08

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